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Comment Letter: Fiduciary Duty Guidance for Proxy Voting Reform

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Investor proxy voting practices have entered the public spotlight in 2018 as Congress and the Securities and Exchange Commission ("SEC") consider changes to the rules which govern proxy voting. However, an accurate recognition of the investor fiduciary duties which provide the legal context for exercise of proxy voting rights has been largely missing from the debate.

We believe that any reform discussions should be anchored on an up-to-date understanding of how fiduciary principles fit the 21st century. This includes a balanced application of the fiduciary duties of (a) prudence (including the obligation to investigate and verify material facts), (b) loyalty to beneficiaries (with its obligation to treat different beneficiary groups impartially), and (c) reasonable management of costs. These are legal duties which establish expectations for proxy voting processes at asset owners, investment managers and proxy advisors.

We also believe that improved alignment of proxy voting policies and procedures with these fiduciary duty fundamentals could improve company and investor performance over time and reduce exposure of fund beneficiaries to systemic risks. This realignment could be driven by greater investor and proxy service provider focus on (a) the evolving research and knowledge base that leads proxy voting trends, (b) oversight of how proxy voting conflicts of interest at investment managers are managed, (c) explicit attention to balancing short- and long-term effects of aggregated proxy votes, (d) consideration of systemic risks that can spread across portfolio companies and compound over time, and (e) recognition of the long-term benefits, as well as the costs, associated with opportunities to collaborate on these fiduciary process improvements.

Proxy Voting as a Fiduciary Function

Investor fiduciaries have long known that proxy voting must be managed in accordance with fiduciary duties. Both the US Department of Labor ("DOL") and SEC have issued guidance in the past few years reconfirming that proxy votes are rights which must be prudently exercised consistent with the interests of pension plan members and fund investors.

For example, in DOL Interpretive Bulletin 2016-01, the DOL noted, “The Department’s longstanding position is that the fiduciary act of managing plan assets which are shares of corporate stock includes decisions on the voting of proxies and other exercises of shareholder rights.”

In Staff Legal Bulletin No. 20 (June 30, 2014), the SEC confirmed, “As a fiduciary, an investment adviser owes each of its clients a duty of care and loyalty with respect to services undertaken on the client’s behalf, including proxy voting.”

Understanding how these fiduciary duties apply to proxy voting deserves a closer look.

Duty of Prudence

Investor fiduciaries are required to exercise their management responsibilities prudently, in a fact-based and forward-looking manner, with reference to the care, skill, diligence and prudence used by similar investors. This contemplates the use of processes which recognize practices at similar peers as a reference point. An understanding of peer practices is required, but the duty of prudence does not create a mindless lemming standard. Instead, it contemplates consideration of peer practices in the context of each fund’s unique structure, risk appetite, strategy, governing documents and liabilities.

The duty of prudence also requires that fiduciaries have a reasonable process in place to investigate and verify facts relevant to investment decisions. Personal preferences and beliefs (whether liberal or conservative) are insufficient to support fiduciary decisions, including those relating to proxy votes.

Evolution of Prudent Practices

A current application of fiduciary principles includes understanding that prudent practices evolve over time. The Restatement of Trusts (Third), a leading authority on investor fiduciary law, confirms that fiduciary practices cannot remain static. “Trust investment law should reflect and accommodate current knowledge and concepts. It should avoid repeating the mistake of freezing its rules against future learning and developments.”

Investor fiduciaries must be especially attuned to changes in investment theories, knowledge base and industry practices. We are currently at such an industry inflection point. For instance, BlackRock’s January 2018 letter to the world’s largest companies highlighted fiduciary duty as requiring a new emphasis on company long-term strategic planning, sustainability and understanding of social purpose. BlackRock announced it is doubling the size of its investment stewardship team to implement company engagement on this obligation. Similar letters to companies that emphasize materiality of long-term value creation and sustainability practices were also sent by industry giants State Street Global Advisors and Vanguard.

Regulators have also acknowledged that understanding of the materiality of environmental, social and governance (“ESG”) factors for long-term investors has been evolving. The DOL December 2016 Interpretive Bulletin confirmed that ESG factors can be material to proxy voting decisions and sustainable value creation. The materiality of ESG was subsequently reaffirmed in a 2018

Field Assistance Bulletin, which restated that ESG factors can be significant drivers of company and investor success.

> "[There] may be circumstances, for example involving significantly indexed portfolios and important corporate governance reform issues, or other environmental or social issues that present significant operational risks and costs to business, and that are clearly connected to long-term value creation for shareholders with respect to which reasonable expenditure of plan assets to more actively engage with company management may be a prudent approach to protecting the value of a plan's investment."

In fact, levels of mainstream investor support for ESG shareholder resolutions have been increasing.

- BlackRock, Vanguard, Fidelity and American Funds, amongst the largest mutual fund investors in the world, began voting in favor of climate-related resolutions in 2017.
- E&Y found that favorable votes of 30 percent or more (a level at which boards begin to pay serious attention) on environmental and social shareholder resolutions increased from 29 percent of those resolutions in 2017 to 41 percent in 2018, a significant upward trend.
- The Climate 50/50 Project identified increasing large mutual fund support for shareholder proposals on key climate change and political influence disclosure resolutions at carbon-intensive companies but also identified a clear pattern of trend leaders and laggards. For example, during the last proxy season Legal and General and PIMCO voted in favor of 100% of the political influence disclosure resolutions while Vanguard, Prudential, BlackRock and JP Morgan supported none.

A prudent proxy voting process requires an understanding of the drivers for such trends in peer voting practices. The duty to investigate and verify material facts also compels evaluation of current research findings (as well as company disclosures) to ensure voting decisions are based on an up-to-date factual investigation. These responsibilities are shared by named asset owner fiduciaries and investment managers to whom proxy voting is delegated and require ongoing fiduciary oversight.

Duty of Loyalty

Investor fiduciaries must also exercise their responsibilities with absolute loyalty to the interests of fund participants and beneficiaries, managing assets to provide promised benefits and cover reasonable administrative expenses. Section 404 of the Employees Retirement Income Security Act ("ERISA") explicitly provides "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries." This is intended to guard against harm to beneficiaries from self-dealing, fraud and personal biases of delegated fiduciary agents.

Conflicts of Interest

When it established proxy voting rules in 2003, the SEC recognized potential for investment manager conflicts of interest in voting proxies and mandated, "To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own." For example, conflicts of interest can result from service fees received from companies on whose proxies votes are being cast, business interests in attracting new public company clients and manager compensation structures that are misaligned with the interests of fund participants. Of particular note for current regulatory debates is that investment managers and proxy advisors owe fiduciary duties to their investor clients rather than to subject companies.

Managers with delegated proxy voting authority typically disclose to clients their general conflicts arising from business interests and engage independent proxy advisors to apply established voting guidelines. Nevertheless, concern about the effect of conflicts on proxy voting persists.

In 2009, the SEC imposed fines on Intech Investment Management and its Chief Operating Officer for allegedly using a labor-friendly proxy voting policy at non-labor client funds to serve the manager's own business interests in attracting new labor fund clients. The SEC noted that "advisers may use a 'predetermined voting policy,' such as a third-party proxy voting service's platform, to vote proxies provided that the predetermined policy is 'designed to further the interests of clients rather than the adviser.'"(Emphasis added.)

Although there is only one reported 2009 SEC enforcement action, a number of academic studies have identified apparent widespread links between mutual fund business interests and their proxy voting patterns. This could be a significant fiduciary issue—and one that merits the attention of both regulators and the asset owners who delegate proxy voting to fund managers. While we do not contend that investment manager conflict situations always involve Adviser Act or fiduciary duty violations, many readers might conclude there is more evidence that investment manager conflicts of interest are influencing some voting decisions than there is supporting other proxy voting conflict of interest allegations currently being debated.

Public Statements and Vote Consistency

Recent public statements from investment managers regarding material ESG factors and systemic risk exposures also present an opportunity for asset owner fiduciaries that have delegated proxy voting authority to conduct congruity analyses of proxy votes with those public statements. The results could help fiduciaries identify situations where a delegated manager's proxy voting processes might not be adequate to ensure that votes are always being cast in the interests of fund participants and not being influenced by the manager's own business interests. Additional scrutiny and inquiries regarding compliance might be merited where inconsistencies are apparent.

As an example of how such potential inconsistencies might present, BlackRock states in its *Investment Stewardship 2018 Annual Report*, "During our direct engagements with companies, we address the issues covered by any **shareholder proposals that we believe to be material to the long-term value of that company**. **Where management demonstrates a willingness to address the material issues** raised, and we believe progress is being made, **we will generally support the company and vote against the shareholder proposal**." (Emphasis added.)

On the surface, this stated practice of voting against shareholder resolutions that have been determined to be in the best interests of the company suggests there is a preference for supporting management over the interests of clients in improving company performance as soon as practical. The resulting disconnect between value creation and proxy voting sends mixed signals to clients, the company and the marketplace. It could have the practical effect of giving companies more room to ignore or delay value enhancing actions.

Some clients might be concerned that a manager's interests in attracting or keeping business from companies could be causing such disconnects between voting practices and company value creation. Disconnects might result from misunderstanding that the fiduciary duty of loyalty in the exercise of proxy voting rights runs only to fund beneficiaries (who will benefit from improving company performance as soon as practical) rather than to the interests of company management or business goals of the fund manager. Or they might be a result of the tension between beliefs about advantages of relying only on continued engagement with a company over first sending a consistent proxy vote message and then offering to continue dialogue.

In any event, when proxy voting responsibilities are delegated, the named fiduciary still retains oversight duties. Robust reporting and monitoring procedures are necessary to put teeth into compliance with the duty of loyalty when voting duties are delegated.

Duty of Impartiality

The duty of impartially (often considered part of the duty of loyalty) requires that fiduciaries balance conflicting interests of different beneficiary groups. This requires consideration of cross-generational equity and other potentially conflicting interests among beneficiaries. Like the

duty of prudence, impartiality contemplates that fiduciaries diligently attend to identification and management of conflicting beneficiary interests. Attention to alignment of time horizons with fiduciary decision processes is especially important for implementation of impartiality duties.

The potential for uncompensated transfer of risks and wealth creation between generations can be exacerbated by myopic investment practices that undermine sustainable long-term corporate wealth creation and favor older over younger fund participants. A growing body of research has found that companies which maintain the discipline to focus on long-term strategic planning and risk management can substantially outperform other companies over the long term. Proxy votes on issues relating to executive compensation plan design, climate change exposure, mergers and acquisitions, election of directors, reporting on sustainability risks and similar matters can have long-term value creation implications which should be covered in proxy analyses.

Systemic Issues can Raise Duty of Impartiality Concerns

In addition, systemic issues are often invisible to fiduciaries that focus exclusively on generation of short-term returns or are evaluated against only a market-relative performance benchmark. Nevertheless, systemic risks can spread across portfolio companies and compound over time, increasing risk exposures and degrading future returns of fund participants. The potential for inequitable intergenerational treatment in the resulting transfer of risk and value is high.

Climate risk presents perhaps the most obvious systemic risk. However, other things like future value destruction from environmental damage and wealth creation limits imposed by ecosystem decline or the effects of excessive income inequality on consumer demand and political risk also raise impartiality concerns. The duty of impartiality requires analysis and a good faith effort to balance fund participant intergenerational and other beneficiary group conflicts as part of proxy voting processes. Use of decision processes that are aligned with efforts to balance short- and long-term value creation and consider systemic risks are critical to fulfilling impartiality obligations—especially for younger plan participants who are more likely to be harmed over the long term by inattention to the duty of impartiality.

ESG and sustainability issues, in particular, often have systemic or long-term cost, risk and return implications. Proxy policies and analyses that do not take this into consideration are likely to raise duty of impartiality and prudence concerns, especially in regard to identification and balancing of inter-generational risk, cost and wealth creation transfers. Analysis of the intergenerational effects of climate change, natural capital restraints, excessive income inequality, health and safety risks, reports on long-term strategic planning, executive compensation plan design, board succession planning and similar matters would help investor fiduciaries implement impartiality obligations.

Duty to Manage Costs

Put simply, wasting the money of participants and beneficiaries is imprudent. A fiduciary must be alert to balancing projected benefits against the likely costs when selecting, delegating duties to and compensating an agent, such as an investment advisor or manager. This involves the exercise of discretion, under the circumstances, with the care, skill, diligence and prudence used by similar investors. However, it does not mandate selection of the lowest cost provider, as consideration of the net cost-benefit result over an appropriate time period with an acceptable level of risk is contemplated.

There are signs that industry standards are also evolving in regard to striking the balance for what costs are reasonable when engaging agents or advisors to assist in implementation of proxy voting responsibilities. For example, BlackRock recently announced it is doubling its staff allocated to corporate engagement and proxy voting. Knowledge about the collective role that investors can play in creation and management of systemic risks that influence long-term investment outcomes is growing. Availability of proxy advisors, new data sources and investor collaboration networks also allow for greater efficiency through cost and work sharing. These cost management and service improvement opportunities must be considered by investor fiduciaries in order to fulfill their cost management obligations.

One practical implication of this is that most investor fiduciaries are essentially obligated to use proxy advisors and similar service providers in order to control costs and improve their ability to exercise informed proxy voting rights. It would be imprudent for them to ignore these cost and work sharing opportunities.

That does not mean that the quality of services provided by agents and other entities in the proxy voting service chain cannot be improved. However, improved alignment of proxy voting with fiduciary duty principles would undoubtedly involve additional costs. This would require that investor fiduciaries conduct a prudent balancing of the related costs and benefits over an appropriate time period and with an acceptable level of risk. Use of such an evaluative process is their legal obligation.

Conclusion

Shareholder voting is an essential corporate governance right under state laws. It is an important channel of communication between shareholders and companies that supports corporate governance balance between the board, shareholders and management. Accordingly, integrity and alignment of the proxy voting process are critical investor fiduciary concerns.

Decisions on management of the proxy processes, service standards and related costs for administration of proxy voting constitute investor fiduciary acts that should be linked with implementation of fiduciary obligations. Legal obligations of prudence, loyalty and cost management are rooted in the common law of trusts and transcend the debates currently occurring at the SEC and in Congress. Application of a 21st century understanding of these fiduciary duties serves as a guide for proxy voting policies, analyses and reports.

The keys to improving alignment of proxy voting policies and practices with fiduciary duties include a greater focus by investor fiduciaries and their service providers on:

- Evolution in knowledge, research findings and related developments which lead trends in proxy voting;
- Oversight of how conflicts of interest in the proxy voting and investment management chain are managed;
- Balance between the short- and long-term effects of proxy decisions on different groups of fund beneficiaries over their varying investment time horizons;
- Aggregated influence of shareholder voting practices on systemic risks that can spread across portfolio companies and compound over time; and
- Cost-benefit considerations in management of proxy voting services.

We believe that greater attention to these fiduciary duty fundamentals could help drive an increase in company and investor performance over the long term, enhance sustainability and encourage more effective management of systemic risks. This has implications for the content of proxy analyses, staffing of proxy voting functions and structure of proxy policies. However, both companies and investment fund beneficiaries are likely to benefit from improved alignment of proxy voting management processes with an up-to-date application of fiduciary duty principles.

The complete letter, including footnotes, is available here.